## **TESTIMONY OF**

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On behalf of the

## CONFERENCE OF STATE BANK SUPERVISORS

On

CALCULATED RISK: ASSESSING NON-TRADITIONAL MORTGAGE PRODUCTS

Before the

SENATE BANKING, HOUSING AND URBAN AFFAIRS

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SUBCOMMITTEE

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#### Introduction

Good morning, Chairman Allard, Chairman Bunning, Ranking Member Reed, and Ranking Member Schumer. My name is Felecia A. Rotellini, and I serve as the Superintendent of Financial Institutions for the state of Arizona. I am also a member of the Board of the American Association of Residential Mortgage Regulators (AARMR). I am pleased to testify today on behalf of the Conference of State Bank Supervisors (CSBS).

CSBS is the professional association of state officials responsible for chartering, supervising, and regulating the nation's 6,230 state-chartered commercial and savings banks. For more than a century, CSBS has given state supervisors a national forum to coordinate, communicate, advocate and educate on behalf of state financial regulation.

In addition to regulating banks, 49 states plus the District of Columbia currently provide regulatory oversight of the mortgage industry. The one exception is Alaska, which introduced legislation this year. Under state jurisdiction are more than 90,000 mortgage companies with 63,000 branches and 280,000 loan officers and other professionals. In recent years, CSBS has been working with AARMR, a volunteer organization of state officials responsible for the administration and regulation of residential mortgage lending, servicing and brokering, to improve state supervision of the mortgage industry.

Thank you for inviting CSBS here today to discuss non-traditional mortgage products. Regulation of the mortgage industry originated at the state level and has remained there because mortgages are the most locally-oriented of all financial products. For most families, no financial decision is more important than the financing they choose

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<sup>&</sup>lt;sup>1</sup> The above numbers do not include the State of California's Department of Real Estate's approximately 480,000 licensed real estate agents who could also function as a mortgage broker under their license.

to obtain their home. CSBS commends our federal banking counterparts in their efforts to provide supervisory guidance for federal financial institutions on non-traditional mortgage products. Effective supervision of the mortgage industry requires a coordinated effort among the federal agencies and the states. It is therefore vital that the states are involved with coordinating policy, regulation, and guidance. State supervision of the residential mortgage industry is evolving to keep pace with the rapid changes occurring in the marketplace. At present, state regulation of the mortgage industry is limited in its consistency. On an individual basis, however, the states' standards are quickly improving and adapting. Through CSBS and AARMR, the states are working together to improve coordination of state supervision as well as to provide best practices and more uniformity.

# **Evolution of Mortgage Industry**

The residential mortgage industry has changed dramatically over the past two decades. Twenty years ago, federal and state regulated savings & loans originated most of the residential mortgages. Federal government-sponsored enterprises or agencies such as Fannie Mae, Freddie Mac, and the Federal Housing Administration (FHA) held a significant percentage of the market share and effectively set standards for the entire industry. At the time, the majority of mortgages were fixed-rate 15- or 30-year mortgages.

Today, mortgage markets have changed. Savings & loans comprise a minority of the market, loans sold to Fannie and Freddie or insured by FHA now account for less than half the market, and the product choices for consumers have exploded. Consumers can now choose between practically any combination of fixed, adjustable, or hybrid adjustable rate and amortizing, non-amortizing, or negatively amortizing mortgages, with terms

anywhere from 15 to 50 years. On top of these changes, risk-based pricing has allowed more consumers than ever to qualify for home financing sooner, by trading a lower credit score or down payment for a higher rate.

More than ever before, homebuyers now view their home as a financial asset. In addition to providing protection from the elements, homes today are seen as a source of financial security for the future. Mortgage lenders have developed a number of products that offer homebuyers a wide variety of choices as they manage this financial asset. Increasingly, many of these products are quite complex, providing both opportunities and perils for consumers. Greater consumer confusion also creates greater opportunities for fraudulent sales practices. The sophisticated nature of these products requires an elevation of professionalism in mortgage originators and robust oversight of the companies and people offering such products.

Recognizing the evolving nature of the industry and its supervisory challenges, most state legislatures have passed laws to regulate mortgage brokers, lenders, and/or loan officers. Under our current regulatory system, the state regulatory agencies have shouldered the primary responsibility for overseeing the residential mortgage industry.

As the mortgage industry has rapidly evolved, the states have played a more active role in its supervision. Forty-nine states and the District of Columbia now regulate mortgage companies and/or professionals. This is a dramatic change since 1993, when only 18 state agencies regulated the mortgage industry. According to industry experts, <sup>3</sup>

<sup>&</sup>lt;sup>2</sup> Source: Mortgage Asset Research Institute, Inc., Reston, Virginia.
<sup>3</sup> Source: Wholesale Access, Columbia, Maryland. <a href="http://www.wholesaleaccess.com/7\_28\_mbkr.shtml">http://www.wholesaleaccess.com/7\_28\_mbkr.shtml</a>.

mortgage brokers and state-licensed loan correspondents now originate an estimated 68 percent of all residential mortgage loans in the United States.

The increasing role that brokers play in the residential mortgage process, concerns about predatory lending, the explosion of product choices offered by the private sector, and the realignment of the federal role in housing finance have required the states to develop new tools to protect consumers and to ensure that mortgage markets operate in a fair and level manner. This trend is most evident in the number of state legislatures that have enacted legislation designed to eliminate unethical practices, remove bad actors, and ensure transparency for consumer.

## **Trends in Non-Traditional Mortgage Products**

Some states, including my home state of Arizona, have seen particular growth in non-traditional mortgage products, such as interest-only and adjustable-rate mortgages (ARMs). "Stated income" loans are also becoming more popular among consumers. Some borrowers use these complex non-traditional mortgage products not as methods to manage wealth, but as means to afford homeownership, or to purchase a home that would traditionally be considered out of their price range.

In some cases, the borrower does not fully understand how these products work.

Sophisticated buyers understand the non-traditional mortgage products and the financial risks. Based upon the consumer complaints the Arizona Department of Financial

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<sup>&</sup>lt;sup>4</sup> "Stated income is a loan feature wherein a mortgage lender requires a borrower to state their income in qualifying for a mortgage but does not require substantiating documentation from the borrower or the loan originator of the income stated. Stated income loans are one of several types of "reduced documentation" loan features that include "low- and no-document," "no income/no asset," and "stated asset" loans that establish reduced or minimal documentation standards necessary during origination to substantiate a borrower's income and/or assets.

Institutions receives, many buyers do not understand the terms or realize the negative consequences of these loans only after the minimum monthly payment has increased. These borrowers claim that they would not have agreed to this type of loan had they known how much the payments would increase in such a short period of time. In many cases, the loan documents include disclosures outlining the interest rate increases and the nature of the product. It appears that many borrowers are so anxious to buy a home that they are willing to take any risk without fully understanding the depth and breadth of the negative consequences.

The current disclosure documents are too complex, and fail to provide consumers with the information they need to protect their interests. CSBS believes that an entirely new disclosure process is necessary to help consumers keep pace with the ever-expanding array of mortgage products.

If properly managed and offered to borrowers in the right situation, non-traditional mortgages may promote homeownership, and in some cases, may lower the long-term costs of homeownership. However, we have seen signs that some underwriting criteria may be inadequate, and some lenders offer these loans in cases where they do not match borrowers' needs. If these are systemic trends, the recent run-up in housing appreciation may be unsupportable.

As a large number of non-traditional mortgage loans re-price and the residential real estate market continues to cool, we fear borrowers may face significant payment shock, or that these mortgages may be unsustainable at fully-indexed rates. These scenarios will likely lead to increased home foreclosures.

Housing and mortgage lending is a significant driver for economic activity. In an environment of higher interest rates, an economic and/or housing market downturn coupled with a high number of borrowers struggling to keep their homes may worsen a negative cycle or speed up any downturn. These non-traditional mortgage products may make a "soft" landing more unlikely.

## **CSBS-AARMR National Residential Mortgage Licensing System**

It is within the context of the growing importance of mortgage brokers in the origination process and significant growth of non-traditional mortgage products offered by state-regulated mortgage brokers and lenders that state regulators find themselves compelled to develop policies and initiatives to safeguard consumers and to protect the economic well-being of their communities. CSBS and AARMR have discussed how our two organizations could best combine the immediacy of local supervision and enforcement with a system that would provide nationwide information sharing and other resources, while at the same time modernizing the state systems.

The result of this discussion was a residential mortgage licensing initiative to create uniform, national mortgage broker and lender licensing applications and a centralized database to house this information. The uniform application and database will significantly streamline processing of licenses at the state level. Additionally, the state agencies will be able to divert resources previously used for processing applications to more supervision and enforcement.

The database will also offer homebuyers a central place to check on the license status of the mortgage broker or lender they wish to do business with, as well as a way to

determine whether a state has taken enforcement action against that company or individual.

Since January 2005, state regulators have committed staff to develop this project.

These individuals have met monthly to work through state differences and develop uniform applications. Over 20 months, hundreds of conference calls, countless revisions, and consultation with the industry, four national uniform application forms were created.

CSBS expects several states to begin using the forms next month.

In June 2006, CSBS contracted with the National Association of Securities Dealers, Inc. (NASD) to develop a nationwide licensing system. The NASD developed and now operates the Central Registration Depository (CRD) ® and the Investment Adviser Registration Depository (IARD) ® system. The NASD brings to this project expertise in developing and operating a national licensing system that is subject to state regulations.

The national database will contain licensing information, enforcement actions, and background data for every state-licensed mortgage broker, mortgage lender, control person, branch location, and loan originator. Each state will continue retain its authority to license and supervise, but the new system will eliminate unnecessary duplication and implement consistent standards and requirements across state lines.

The electronic application and database system will begin operations on January 1, 2008.

Once up and running, database information will be available not only to regulators and law-enforcement officials, but also to the licensees and to consumers. The database will provide immediate and profound benefits to consumers, the industry, and the state supervisory agencies. Consumers will have access to key information about the providers

that they trust with the most important financial transactions of their lives. Honest mortgage bankers and brokers will benefit from the creation of a system that drives out fraudulent and incompetent competitors, and from having one central point of contact for submitting license applications. Everyone benefits from a system that makes it easier to identify and punish the small percentage of dishonest operators in the mortgage industry.

This system will play an important role in discussions about non-traditional loan products. In a sense, the changes in the mortgage industry are similar to some of those in the securities industry. Today, more homebuyers view their home as a financial asset. Mortgage companies have developed a number of products that offer homebuyers a wide variety of choices in how to manage this asset. Some of these choices are complicated and are priced on risk, which requires increased education, professionalism, and oversight of those offering these complex products to consumers.

Therefore, the changes in the mortgage industry over the past 20 years requires a more robust licensing system akin to that developed by the Securities and Exchange Commission (SEC), the National Association of Securities Dealers (NASD) and the states for securities brokers.

Given the changes mortgage products and the increased role of brokers, CSBS believes that it is in regulators', consumers', and the mortgage industry's interest to move to the coordinated oversight that the CSBS-AARMR licensing system and database will provide.

# **CSBS-AARMR Non-traditional Mortgage Product Guidance**

In December 2005, the Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (FRB), the Federal Deposit Insurance Corporation (FDIC), the Office of Thrift Supervision (OTS), and the National Credit Union Administration (NCUA) published a notice of proposed guidance on non-traditional mortgage products. When finalized, the guidance will apply to all banks and their subsidiaries, bank holding companies and their nonbank subsidiaries, savings associations and their subsidiaries, savings and loan holding companies and their subsidiaries, and credit unions. CSBS believes this is important and useful guidance, but it will not apply to those mortgage brokers and mortgage companies not affiliated with a bank holding company or an insured financial institution who originate a vast majority of loans.

In an effort to provide guidance for these state-supervised mortgage providers, CSBS and AARMR are developing parallel guidance which will primarily focus on residential mortgage underwriting and consumer protection. The guidance will be offered to state regulators to apply to their licensed residential mortgage brokers and lenders. CSBS and AARMR intend to release this guidance immediately following the publication of the final federal guidance, which is expected this fall. The CSBS-AARMR guidance is intended to hold state-licensed mortgage brokers and lenders to effectively the same standards as developed by the federal regulators. Specifically, the proposed CSBS-AARMR guidance will help ensure that the marketing and borrower disclosure practices of third party originators reflect the standards and practices used by an institution in its direct lending activities.

#### **Mortgage Training Initiatives**

CSBS and AARMR are also working individually to increase the expertise and knowledge of the state supervisors. CSBS has developed and is delivering a comprehensive training program for state residential mortgage examiners. The program, Residential Mortgage Examiner School, is designed to help inexperienced mortgage company examiners understand how the mortgage industry works and also provide them with practical and proven techniques for examining non-depository mortgage companies similar to those used by state and federal bank examiners. The School complements training programs offered by AARMR.

The program features a blended learning format which includes pre-residence session assignments and a 4.5 day residence session. The developers and instructors of the program are experienced state examiners and officials and industry executives.

In addition to the Residential Mortgage Examiner School, other programs are under consideration including a program focusing on non-traditional mortgage products. CSBS also is developing a certification program for mortgage examiners and plans to extend its state agency accreditation program to include mortgage supervision.

AARMR holds Training Schools twice a year, once in the spring and once in the fall. They hold a Basic Examiner School, which provides state residential mortgage regulators/examiners with a brief overview of the mortgage industry and a more comprehensive overview of the federal regulations used during mortgage banking examinations. The school provides an understanding of the industry to new examiners and

is geared towards examiners with one year or less experience examining mortgage companies.<sup>5</sup>

AARMR also holds an Advanced Examiner School, which provides participants with updates on federal regulations and recent trends in the mortgage industry. And finally, AARMR has a Fraud School to provide participants with the skills and tools necessary to identify, understand, and document fraud in the mortgage industry.<sup>6</sup>

#### Conclusion

We have seen dramatic changes in the residential real estate mortgage market. The choice in products has increased, as well as their complexity. Consumers also have greater choice in their service provider. Beyond the traditional bank or savings and loan, a consumer can utilize the services of a mortgage company or mortgage broker. While these choices have in many cases benefited consumers by enabling home purchases and customizing home financing, they have also increased the complexity and dangers in the marketplace, and created more opportunities for outright fraud.

Regulation of the mortgage industry originated at the state level. As the mortgage market has changed, state authorities have enacted new laws and improved overall supervision. The CSBS – AARMR residential mortgage licensing initiative is the cornerstone for a new generation of coordination, cooperation, and effective supervision in the state system.

<sup>&</sup>lt;sup>5</sup> Source: American Association of Residential Mortgage Regulators. http://www.aarmr.org/page07.htm.

CSBS commends the federal regulators for drafting guidance on non-traditional mortgage products. This guidance has done much to draw attention to the threats that these products may pose to consumers, especially if underwriting is done improperly. When the guidance is implemented, it will not apply to the majority of mortgage providers in this country. The parallel guidance being prepared by CSBS and AARMR will help to ensure consumer protection across the mortgage industry.

Finally, the states have proactively worked to increase the expertise and knowledge of their examiners. It is critical for our examiners to understand the function of the mortgage market and its various products. These are the individuals which will see first hand the practices of the industry and its impact on our consumers.

I commend you, Chairman Allard, Chairman Bunning, Ranking Member Reed,
Ranking Member Schumer, and the distinguished members of the Subcommittees for
addressing this matter. On behalf of CSBS, I thank you for the opportunity to testify, and I
look forward to any questions you may have.